

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0108
Sales and Use Tax
For the Years 1998-2001

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ISSUES

I. Sales and Use Tax-Maintenance Agreements

Authority: IC 6-2.5-3-2, IC 6-2.5-2-1(a), IC 6-8.1-5-1(b), Indiana Sales Tax Information Bulletin #2 issued in 1991 and November, 2000, *Gross Income Tax Division v. National Bank and Trust Co.*, 79 N.E. 2d 651 (Ind. 1948).

The taxpayer protests the assessment of tax on certain maintenance agreements.

II. Sales and Use Tax-Software

Authority: IC 6-2.5-5-3(b), IC 6-2.5-5-4, 45 IAC 2.2-5-8, 45 IAC 2.2-5-10 (c), *Indiana Department of Revenue v. Cave Stone*, 457 N.E. 2d 520, (Ind. 1983).

The taxpayer protests the assessment of tax on certain software.

III. Sales and Use Tax-Gerber Plotter, Software, and Replacement Parts

Authority: IC 6-2.5-5-3(b).

The taxpayer protests the assessment of tax on the Gerber plotter, software, and replacement parts.

IV. Sales and Use Tax-Plotter Paper

Authority: IC 6-2.5-5-5.1(b),

The taxpayer protests the assessment of tax on plotter paper.

V. Sales and Use Tax-Forklift Parts

Authority: IC 6-2.5-5-3(b), 45 IAC 2.2-5-10(b)(2).

The taxpayer protests the assessment of tax on forklift parts.

VI. Sales and Use Tax-Sawsall Saw, Blade, and Cable Ties

Authority: IC 6-2.5-5-3.

The taxpayer protests the assessment of tax on the sawsall saw, blade, and cable ties.

STATEMENT OF FACTS

The taxpayer is a manufacturer of soft cloth purses and matching accessories for women. On November 19, 2001 the taxpayer filed a claim for refund of sales tax or use tax paid on certain manufacturing items. The Indiana Department of Revenue, hereinafter referred to as the "department," then conducted an audit encompassing the issues in the claim for refund. The audit denied portions of the claim for refund and assessed use tax on other purchases. The taxpayer protested certain findings in the audit. A hearing was held. This Letter of Findings results.

I. Sales and Use Tax-Maintenance Agreements

DISCUSSION

The taxpayer purchased several maintenance or extended warranty service agreements including equipment repair, software support, and telephone support. The department assessed use tax on each of these agreements. The taxpayer protested these assessments.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC 6-8.1-5-1 (b). All exemptions must be strictly construed against the party claiming the exemption. *Gross Income Tax Division v. National Bank and Trust Co.*, 79 N.E. 2d 651 (Ind. 1948).

Indiana imposes a sales tax on retail transactions made in Indiana. IC 6-2.5-2-1(a). A complimentary tax, the use tax, is imposed on tangible personal property stored, used, or consumed in Indiana when no sales tax was paid at the time of the purchase. IC 6-2.5-3-2 (a). The department's policy concerning the application of the sales tax and use tax to maintenance or extended warranty service agreements is found in Indiana Sales Tax Information Bulletin #2 issued in 1991 and November, 2000. Both editions have language similar to the following found in the November, 2000 issue concerning the application of sales or use tax to maintenance agreements:

Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.

The taxpayer contends that the protested warranties are not subject to the sales tax or the use tax because replacement parts will only be provided if they are necessary. Therefore, there is only

an intangible right to have tangible personal property. There is no guarantee that replacement parts will be provided. Although the agreements guarantee that additions and upgrades to the software will be supplied if produced, there is no guarantee that they will be produced. Since there is no guaranty that property will be supplied during the warranty period, the warranties are not subject to sales tax.

FINDING

The taxpayer's protest is sustained.

II. Sales and Use Tax-Software

DISCUSSION

The taxpayer also protests the assessment of use tax on certain software. This software programs cutting machines by translating the design into the machine language and putting the design information into the machine so that the machine can properly cut the taxpayer's product.

The taxpayer contends that this use of the software qualifies for the direct use in direct production manufacturing exemption pursuant to IC 6-2.5-5-3(b) as follows:

Transactions involving manufacturing machinery, tools, or equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

In *Indiana Department of Revenue v. Cave Stone*, 457 N.E. 2d 520, (Ind. 1983) the Indiana Supreme Court found that a piece of equipment qualifies for the manufacturing exemption if it is essential and integral to the production process. 45 IAC 2.2-5-10 (c) further describes manufacturing machinery and tools as exempt if they have an immediate effect on the property in production. IC 6-2.5-5-4 extends the exemption to tools used to build exempt machinery and equipment. This exemption is clarified at 45 IAC 2.2-5-8:

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) Pre-production and post-production activities. Direct use in the production process: begins at the point of the first operation or activity constituting part of

the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

The software in question does not have an immediate effect on the purses, suitcases, and other bags produced by the taxpayer. Rather, the software programs the cutting machines so the cutting machines cut the materials to the specifications. This software is used outside the production process and has an immediate effect upon the cutting machines rather than the bags produced by the taxpayer during the production process.

FINDING

The taxpayer's protest is denied.

III. Sales and Use Tax-Gerber Plotter, Software, and Replacement Parts

DISCUSSION

The taxpayer also protests the assessment of use tax on the Gerber plotter, software, and replacement parts contending that they qualify for the "direct use in direct production" exemption at IC 6-2.5-5-3(b). The Gerber plotter, software, and replacement parts are used to produce patterns. The production of patterns is not a part of the production process of cutting of fabric to be sewn into bags. The preparation of the patterns is not a part of the direct production process and does not have the required immediate effect upon the production process required for exemption from use tax.

FINDING

The taxpayer's protest is denied.

IV. Sales and Use Tax-Plotter Paper

DISCUSSION

The taxpayer also protests the assessment of use tax on the plotter paper. The taxpayer contends that the plotter paper qualifies for exemption pursuant to IC 6-2.5-5-5.1(b) as follows:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

The plotter paper is used in several areas of the taxpayer's facility. It is used as a pattern and for labeling for inventory control on stacks of material in the cutting process. It is also used for developing designs and planning the cutting of these designs in order to prevent waste of fabric. Any plotter paper used in the development and planning portion of the operation is outside the

production process and is clearly subject to the use tax. The taxpayer did not offer any breakdown of the use of the plotter paper. If the plotter paper that is used in a taxable manner cannot be segregated from the plotter paper possibly used in an exempt manner, all the plotter paper must be considered subject to the use tax. The taxpayer has not sustained its burden of proving that some of the plotter paper is exempt from the use tax.

FINDING

The taxpayer's protest is denied.

V. Sales and Use Tax-Forklift Parts

DISCUSSION

The taxpayer uses three forklifts in its operations. One is used to unload raw materials from trucks and to place these items in the raw material warehouse. The two other forklifts are used to load and unload the work-in-process carts onto trucks for shipment to the purse assemblers. The department and the taxpayer agree that the two forklifts used to load and unload the work-in-process qualify for the direct use in direct production manufacturing exemption pursuant to IC 6-2.5-5-3(b).

45 IAC 2.2-5-10 (h) (2) further clarifies the exemption by allowing the exemption of "Replacement parts, used to replace worn, broken, inoperative or missing parts or accessories on exempt machinery and equipment . . ." Since two of the three forklifts qualify for exemption, 2/3 of the forklift replacement parts qualify for exemption. The taxpayer contends that the auditor miscalculated the amount of the exemption in the audit. A review of the audit and invoices submitted by the taxpayer indicates that the auditor assessed tax on 1/3 of the purchase price listed on the invoice of each forklift replacement part. Therefore, exemption was properly granted for 2/3 of the purchase price listed on each submitted invoice.

FINDING

The taxpayer's protest is denied.

VI. Sales and Use Tax-Sawsall Saw, Blade, and Cable Ties

DISCUSSION

The taxpayer also claims that the use of the sawsall saw, its blade, and cable ties qualifies these items for the manufacturing exemption from the sales tax pursuant to IC 6-2.5-5-3. The production of purses begins with the ripping of material into strips. The strips of material are then rolled onto cardboard tubes. The sawsall saw cuts the tubes into sections so that it can be sent to the sewers to become purse straps, a component part of the final product. It is used in the production process in an integral fashion by actually changing the material so that it can be

further processed into a component of the final product. Therefore, the use of the sawsall saw and its blade is exempt from the sales tax.

There was no explanation of the use of the cable ties given. Therefore, the taxpayer did not sustain its burden of proving that the use of the cable ties qualifies them for exemption from sales tax.

FINDING

The taxpayer's protest is sustained as to the sawsall saw and blade. The taxpayer's protest to the sales tax on the cable ties is denied.

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